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SUBJECT: SHADOW BOXING: TURKEY'S UNREGISTERED ECONOMY

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11. (SBU) Summary: Turkey's economic success over the last four years has prompted renewed discussion about the need to move on to tackle other deep-rooted structural problems in the Turkish economy. Chief among these issues is Turkey's shadow (or unregistered) economy, which experts estimate represents anywhere from a third to a half of the country's economic activity. The problem crops up in the context of virtually every other economic issue-- from the difficulty banks will have implementing Basel II standards because of the lack of reliable balance sheets in most Turkish companies to the lack of a level playing field for foreign investors, when they confront competition from companies that do not pay tax or required benefits. Economists here are divided on how Turkey can best address the issue, but most appear inclined to support the IMF's view that tax rates should be lowered only after the country has ratcheted up enforcement and done a better job of collecting payments. In recent months, government leaders have stepped up the rhetoric and indicated that they intend to do just that, but the verdict is out on whether such oft-repeated promises will become reality. End Summary.

12. (SBU) In the Shadows: The true extent of the problem of Turkey's unregistered or "shadow" economy is a matter of hot debate. Most of our Istanbul business contacts, while disclaiming any personal knowledge or involvement in evading taxes or employing workers off the books, estimate that up to half of the Turkish economy is unregistered. Similarly, business surveys cite a majority of Turkish businessmen as saying that the problem of businesses "operating in the shadows" exists in their sectors. Government officials in Ankara have been reluctant to make a definitive estimate, but concede that a figure between a third and a half of economic activity is not out of the question. Academics who have studied the issue in Turkey have produced estimates ranging from 13 to 60 percent, depending on the model used. Most cluster around a figure of 35 percent, which the World Bank's lead economist Rodrigo Chavez cites as a reasonable working assumption.

13. (U) While definitive figures are hard to come by, anecdotal evidence abounds about the pervasiveness of the problem. From disappointed tourists who lack a receipt for the product they purchased at the Grand Bazaar, and who face a higher price when they press for one, to diplomats who encounter bemusement when they attempt to take advantage of their tax exempt status, and find themselves receiving a "discount" rather than a tax credit. More generally the issue is evident in the ability of tiny corner stores (bakkals) to sell products at prices that rival those of the

largest supermarket chains. Local tax collecting officials are also fond of relating stories about the jewelers and doctors who lead lavish life styles in Istanbul but at tax time claim without embarrassment that they make less than the country's minimum wage or (in many cases) nothing at all. For their part, foreign investors point to the presence of unregistered companies as a key disincentive, as the "uneven playing field" they create leaves them at a serious economic disadvantage, while banks rue the difficulties informality creates in accurately assessing the creditworthiness of those seeking loans.

¶4. (U) Nature of the problem: Economists argue that Turkey's shadow economy results from multiple factors: high tax and social security rates, weak inspection and enforcement, poverty, and a tradition of widespread tax evasion, exacerbated by low public confidence in how governments have managed public funds. They add that the phenomenon in Turkey differs from that of other countries in that rarely do companies or individuals operate totally outside the system. Instead, they typically under-report their income, the number of their employees, and the wages they pay. Indeed, while an estimated 53 percent of Turkish workers are unregistered, of those who are registered nearly half are reported as earning the minimum wage. While believable for low-cost rural and Anatolian areas, such compensation is unlikely to be an accurate reflection of earnings in urban areas such as Istanbul, Izmir and Ankara. Recent studies of tax compliance show similar patterns. An anonymous survey of nearly 40,000 taxpayers commissioned last year by Turkey's Tax Administration showed that for every 100 YTL in income that was reported, respondents were concealing another 269 YTL. Corporate taxpayers were slightly more honest, but still concealed 147 YTL of income for every 100 YTL they claimed.

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¶5. (SBU) Coping with Crisis: Both business and government contacts note that the size of Turkey's unregistered economy, after stabilizing and beginning to decline before the 2001 crisis, has since expanded as businesses have sought to survive the crisis years. Indeed, they argue that in a sense the shadow economy functioned as a safety net, permitting small inefficient companies to survive the economic turbulence. Experts at the State Planning Office (SPO) estimate that 90 percent of Turkey's informal employment is in firms employing less than 9 people. Informality thrives, they add, because of Turkey's poverty and unequal income distribution.

¶6. (SBU) Enforcement Deficiencies: Government officials concede that bureaucratic lapses have contributed to the prevalence of the problem. The World Bank's Chavez points out that with a work force of 24 million people and a working age population of nearly 50 million, the Turkish government has only 250 labor inspectors to ensure that Turkish companies are meeting legal requirements. In addition, lack of cooperation between agencies, especially those administering taxes and those administering social security, facilitated informality, in that reported employment levels at the two agencies differed widely. To address the problem, the GOT has moved to merge social security numbers with taxpayer identification numbers, so there will be a single identifying number for registrants.

¶7. (SBU) It is hoped that the single taxpayer number, together with stepped up enforcement and a streamlining of the revenue administration, will improve efficiency. A key IFI-sponsored structural reform, the legislation for which passed parliament in the spring of 2005, was a reorganization of the Tax Administration, making it a semi-autonomous agency with a functional organizational structure and a large taxpayer unit. That unit is designed to do a better job both servicing large taxpayers and enforcing their compliance. Under the reform, Turkey's multiple government bodies responsible for tax audits are supposed to coordinate their

targeting, and regional tax offices now report directly to the Tax Administration rather than to the Ministry of Finance as a whole. Finally, the Tax Administration has invested in a new IT system, to ease its data collection process. U.S. Treasury advisors have provided technical assistance throughout the reorganization process.

¶8. (SBU) Lower rates?: Experts are divided on whether Turkey could improve collections by lowering tax rates, as has been attempted in other countries in the region. Chavez concedes that the jury is out on whether this approach would work, but said the Bank is in the process of examining Turkish Central Bank data which should provide insight into the price elasticity of formal labor. He noted that earlier studies had reached the "counterintuitive" conclusion that such demand was somewhat inelastic, but that the new study should provide a more definitive indication. If the results show some elasticity, he said, the Bank would consider supporting some lowering of labor taxes, provided it was part of an overall package. The countervailing measures would likely not be politically popular, he conceded, and he stressed that the idea would undoubtedly run into strong opposition from the IMF. Indeed, Deputy Representative Christian Keller told us the supply side approach would be a serious risk for Turkey, and he doubts lower rates would lead those who have not registered their workers or paid their taxes to reform. Instead, he said, the Fund believes the proper sequence is for Turkey to improve its tax administration, show more enforcement teeth, and only then think of lowering tax rates. The Fund has cleared lower corporate tax rates, he admitted, but he noted that this was accompanied by abolishment of investment incentives that had encouraged capital-- rather than labor-- intensive production. The overall effect, he claimed, would thus be revenue neutral.

¶9. (SBU) Keller also challenged the argument that Turkey's labor regime is much more onerous than that of other OECD countries. Both Keller and SPO official said that reports indicated that Turkey has the highest tax and social security rates on labor (the "tax wedge") are misleading, as they are based on a unique profile: that of a sole wage-earner supporting a family of four. Results for other classifications place Turkey further down the list, and indeed, the overall results are skewed as Turkey's deduction system does not track with OECD models. (Wage-earners do not receive credits for dependents but for some of their consumption; most studies do not incorporate these unique Turkish deductions, however.)

¶10. (SBU) Think Tank View: Harvard-educated economists at

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Ankara's Economic Policy Research Institute share Keller's doubts. Noting their ongoing work to evaluate Turkey's unregistered economy, they concur that tax rates are not the key determinant of informality; rather cultural mores and economic difficulties explain the phenomenon. Amplifying on the point that Turks do not totally skirt the system, but rather underpay, they noted this leads to the counterintuitive result that a rise in the minimum wage can actually reduce informality, since most "minimum wage" earners actually earn more than that. Raising the minimum wage thus brings their reported earnings closer to the reality. They also argued that their research shows that reducing the tax wedge on labor in Turkey will not reduce informality. "Sticks are more important than carrots," they suggested, so that the key is to ratchet up enforcement, while at the same time simplifying the system and making it less of an (administrative) burden. The key problem for Turkey, they suggested is not the tax and social security burden, but rather the high cost of labor, in comparison to China and India. This point is seconded by Rustu Bozkurt of Sisecam, whose research shows that with the cost of a labor union member exceeding per capita income by 5 times, Turkey's ratio is nearly three times the world average. Decreasing Turkey's labor costs, they argued, will create more flexible

labor markets and help address the informality issue.

¶11. (SBU) New Measures: Turkey's Tax Administration appears to be heeding the experts' counsel, as it has announced a range of measures in recent months to tighten tax enforcement. In addition to the steps to unify tax and social security records, late last month the Revenue Administration's Director General Osman Arioglu announced a range of measures aimed at improving the government's ability to track economic activity. They include placing memory chips in cash registers to follow cash flow, use of electronic tickets for transportation that will immediately be registered in tax offices, as well as on-line links to title offices, banks, interbank card centers, and other bulk trade offices. While the utility of some of the planned measures is not immediately apparent (other tax officials have described to us in detail how henceforth all gasoline purchases will be linked to license plate numbers and electronically tracked), most should aid enforcement. Major lacunae remain, however. One senior tax official related to us that while he can examine taxpayers income records, he still is not able to question individuals about spending that is not consistent with their reported income levels.

¶12. (SBU) Comment: Ministers from Economy Minister Ali Babacan to Finance Minister Kemal Unakitan have declared open season on the unregistered economy and warned that the days of lax enforcement are over. They have also said that no further tax amnesties are on the horizon. Turks have heard such warnings before, however, and until enforcement catches up, are unlikely to be impressed. Still this will be a critical issue for Turkey's economic future, as the country seeks to broaden its tax base and ensure a revenue stream that enables it to meet its financial obligations without discouraging economic activity. End Comment.
JONES